

Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
125 East 93rd Street
New York City 28

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July 1, 1960

Number 109

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PRICE MOVEMENTS. Consider the movements of the Industrial Average. Having failed to confirm the new Rail low at P, the senior Average advanced in a series of two upward zig-zags to a high of 656.42 at point T. Since an upward zig-zag implies both a consolidation and a bettering of a previous peak, the Industrial advance to T was more impressive than would have been the case if the advance had progressed vertically in a string of perhaps eight or nine consecutive rises.

Now consider the Rails. Starting with the secondary high at K (146.56), the carriers retreated to P in a series of two distinct downward zig-zags. Then at P the Rails rallied, and for the first time since January, 1960, a promising structure (P-R-S-T) developed. A rail bettering of T (146.01) would certainly suggest a further advance above K (146.56) and a full confirmation of the Industrial move. If Rails succeed in hurdling these two upside barriers there will be no doubting the fact that the secondary trend of the market has turned bullish in a full Dow Theory sense.

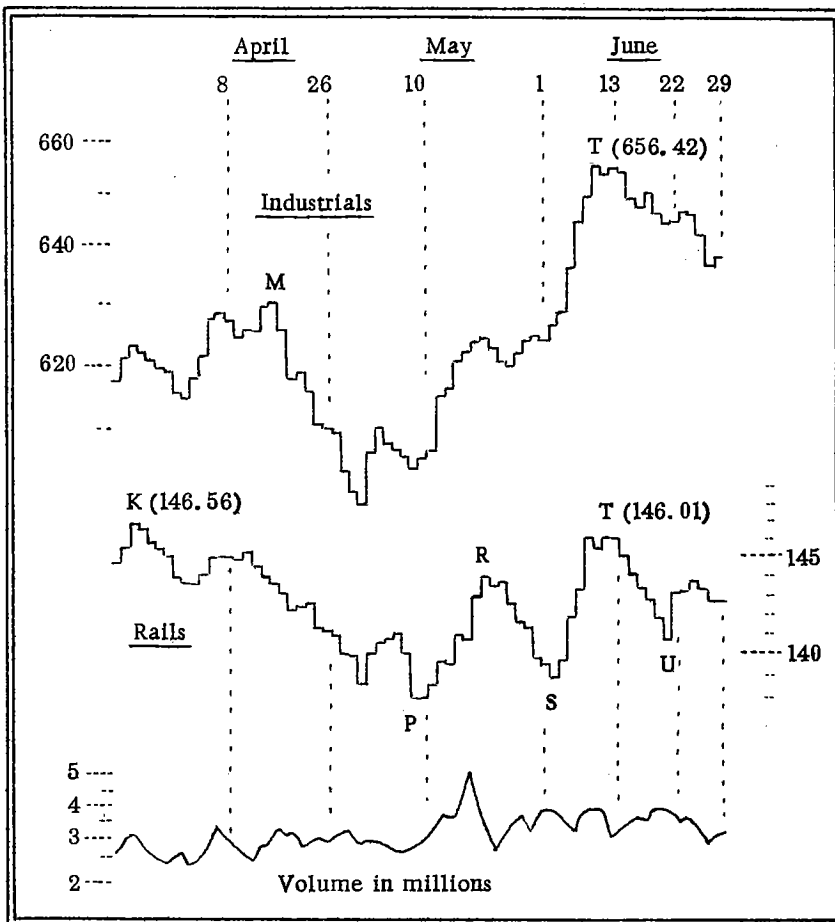
At point U the Rails (having formed a large ascending zig-zag) were in an excellent position for a final confirming rally. So far the confirmation has not materialized. It should be remembered that the primary trend or tide of the market is down, and in a bear market values erode with the passage of time.

For this reason, the longer the Rails resist confirming, the less the odds favor such a movement's developing. The first hint of weakness in the current market could now come from a minor indication -- a Rail violation of point U (141.62) with Industrials declining "in gear".

CONCLUSION. The primary trend is bearish. The secondary trend turned up on March 10, and secondary highs were established by Industrials at T (656.42), Rails at K (146.56). Barring a Rail confirmation above the 146.56 level, the secondary trend must now be classified as obscure. Since point T a series of tiny downward zig-zags formed in the Industrial Average, following which that Average dropped sharply. If Rails violate point U (142.62) the minor trend will be down, with the strong likelihood that the secondary trend has turned down as well.

IN SECONDARY TERRITORY.

Last week steel output dropped below 60% of capacity for the first time in



a non-strike period since the recession summer of 1958. A subscriber writes to say that "the steel situation is now well known to the public and to the market and is therefore thoroughly discounted." A July steel rate of 50% should have little or no effect upon the market, he adds.

This is absolutely correct. I have stated before that in my opinion the market is now concerned only with the third and fourth quarters of 1959 and perhaps with the economic situation as it can be appraised for early 1961. I have also written that if one or both Averages manage to hold above the bear market lows (Industrials 599.10, Rails 137.68) it will be apparent that the worst that can be foreseen over the near term has been discounted. A persistent refusal by one or both Averages to violate the bear market lows would suggest to me that any further important economic damage is likely to be postponed until late 1960 or even early 1961.

Nevertheless, the Rails are now 29 points under their July, 1959, peak, and this highlights the fact that the Averages do not foresee a return to the prosperity of mid-1959. It is also well to remember that the primary indications hold valid for extended periods of time, whereas the minor and secondary indications are short-lived and usually technical rather than fundamental in nature. The market reserves the right to reverse its minor and secondary indications at any time. For this reason, if the two indicators were suddenly to retreat below their bear market lows, the business and market picture would appear ominous.

Following the bear signal, Barron's (March, 1960) published a letter from an irate reader who suggested that I would be held responsible for any forthcoming business and market recession. Four months have elapsed since the bear signal, but I fail to see how a small group of followers of Dow's Theory could have caused the steel shutdowns, the downturn in residential housing and the 18% drop in Barron's Business Index. Economists and statisticians have never cared for Dow's Theory. Perhaps it is because they spend most of their time trying to explain business conditions that have been seen by the Averages many months ahead of the event.

TECHNICAL NOTES. The advance-decline ratio or "breadth" of the market indicator has risen grudgingly during the whole May-June rally. This implies that the advance has not developed a "following". Significantly, during the broad January-March decline the advance-decline ratio dropped 17.5%. During the same time the D-J Industrials lost 86 points. But on the subsequent May-June rally the advance-decline ratio gained only 5.3% -- this despite the fact that the recovery retraced 65% of the losses in the D-J Industrial Average. In other words the primary bear leg of January-March was very broad, but the rally (reaction) back was extremely selective.

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On June 21 the odd-lot ratio swung to more selling than buying, and many analysts accepted this as an indication of underlying market strength, particularly since the June 21 ratio came after a period of increasing odd-lot caution. On June 22 the odd-lot ratio again showed more selling than buying, but this time the percentage of selling slipped slightly. Since then the ratios have tended to move towards slightly more buying. For this reason any bullish conclusions regarding odd-lot ratios must be held in abeyance. As mentioned before, the odd-lots sometimes act as a coincident rather than a lead indicator. Odd-lot balances may swing to extreme caution at the top of a rally only to reverse to the buy side as a decline gets underway. If odd-lots always lead the Averages we would have a perfect system for "beating" the market. As of this writing no such system has been developed.

The odd-lot situation is particularly interesting when contrasted with the consensus opinion of the investment services. The latter (judging from about 12 services which I review) are generally bullish with about half being extremely bullish. Normally, investment service opinion does not vary significantly from odd-lot opinion.

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Because there are times when most of the technical indicators are strongly bullish or bearish, Dow Theorists are prone to use them as a method of outguessing the Averages. Using the technical tools in conjunction with Dow's Theory can be very helpful, but it seems to me that the present situation is one in which the Averages must be allowed to do their own "talking". Certainly the technical position of the market at this point is far from clear.

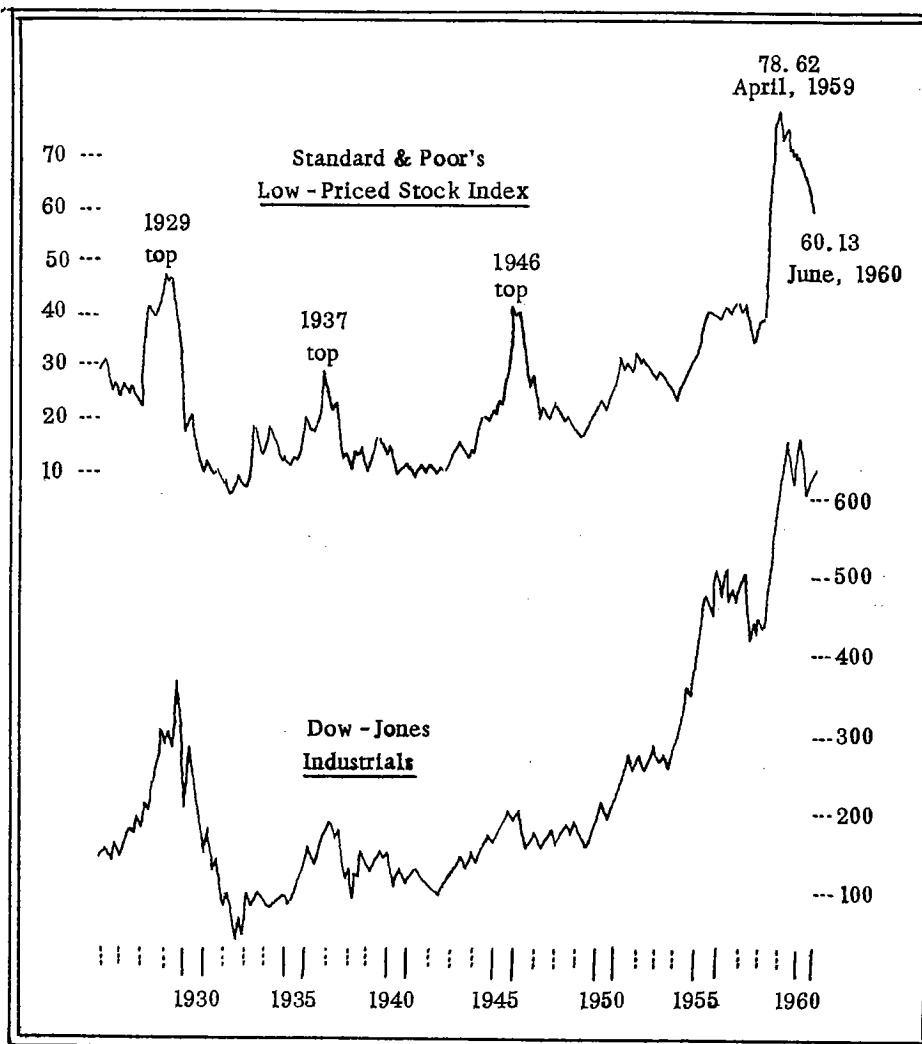
LOW-PRICED STOCK INDEX. The movements of the low-priced (L.P.) stocks have been remarkably consistent over the years. Because of this I consider them to be an excellent indicator of market phase. Letter 94 contained a special study of the L.P. stock Index, and I believe the position of this group to be of particular interest at this time.

The accompanying chart shows that each major bull market's third phase has been underscored by a violent almost vertical advance in the L.P. "cat-and-dog" group. Such a move has always preceded a final topping out of the "blue-chip" D-J Industrial Average. Note the explosive rate of ascent in the L.P. stocks during the final phase of the 1929, 1937 and 1946 bull markets. Note also the "spear-point" top which climaxed each L.P. stock advance. Following each third phase peak, the L.P. stocks fell away as quickly as they advanced.

The current picture suggests that history is repeating itself. From a high of 78.62 recorded in April, 1959, the Standard & Poor's Index of Low-Priced Stocks has dropped 23% to last week's low of 60.13. There have been no "double-tops" in the history of the L.P. Stock Index.

QUESTION. "A trendline extending through the Industrial closings of May 10 and June 1 was broken last week. Isn't this bearish?"

ANSWER. It may well be, but you can't prove it with Dow's Theory. A study of the 64 year history of the Averages points up the wisdom of avoiding conclusions based on trendlines,

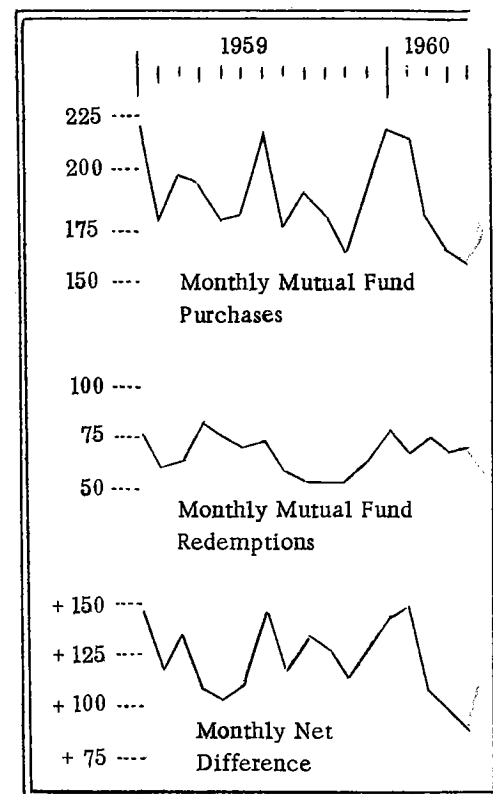


double tops, triangles, flags and other formations. In my own studies I find that I tend to see trendlines when I want them and to ignore them when they interfere with my hopes and wishes.

MUTUAL FUNDS. One of the arguments advanced by the "managed economy" bulls is that the weight of mutual fund buying will serve to cushion any potential collapse in the stock market. But the latest figures on mutual fund sales make fascinating reading in themselves. Note on the accompanying chart that purchases of mutual funds have dropped sharply and steadily from 223 million in January, 1960, to 159 million in May. The interesting thing, however, is that redemptions of mutual funds have held remarkable steady, with May redemptions (71 million) actually lower than January redemptions (78 million). In other words, it was the drop in purchases alone which shrank the monthly gain in mutual fund transactions (purchases minus redemptions) to the lowest figure (88 million) in over two years.

All of which suggests that mutual fund buyers have not turned bearish -- certainly (so far) they have not stepped up their rate of redemptions. It does suggest, however, that the fund buyers may simply be running out of money. But in the event that the fund owners were actually to turn bearish, I would expect them to increase redemptions as well as decrease purchases.

If the squeeze on fund purchases continues, and if any unforeseen incident arises which might serve to produce a rise in redemptions, this chart suggests that mutual funds could easily show monthly net losses instead of diminishing net gains. Such a phenomenon would hardly be a prop under the stock market; on the contrary, it would constitute steady pressure.



A VOICE FROM THE PAST APPLIED TO THE PRESENT. "Much is heard these days about the troubles of the railroads. Wage increases must be met; new equipment is needed; and the costs of everything they use are increasing. The rails are faced with tremendous increases in taxes, and are exposed to every tax-levying body in each city, county, and state in which they operate, besides bearing their share of Mr. Roosevelt's extravagances. But there is nothing new about all of this, and most of it has been foreseen for a year or longer. If the Rails refuse to follow the Industrials' advance, then the industrial improvement will terminate, not only for stocks, but for the businesses represented by those stocks." (Rhea - August 7, 1937)

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(Written Thursday, June 30, 1960 - 12 P.M.)